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Analysis of Financial Fraud Based on the GONE Theory

— A Case Study of Hangzhou Century Co., Ltd.

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Abstract: Convertible bonds allow creditors to convert their claims into company shares under certain conditions. Because of this debt-equity conversion feature, the issuance conditions, pricing and conversion value of convertible bonds are highly susceptible to financial information. Increasing the market value of a company's stock by exaggerating earnings or concealing debt may lead to convertible bond investment decisions based on misinformation, which in turn affects investors and the healthy operation of the market. Based on the GONE theory, this paper analyses the motivation of financial fraud in convertible bond documents and proposes corresponding preventive measures for its characteristics. Through the research and analysis of this type of financial forgery, the preventive governance of financial forgery can be further strengthened, which not only helps to protect the company's reputation and ensure the accuracy and reliability of the financial report, but also helps to attract and maintain the trust of investors, avoid possible legal risks and economic losses, and create a transparent and honest financial environment for the market to promote the efficiency of the market and the fair competition of enterprises.

Keywords: Convertible bonds, GONE theory, Financial fraud.

1. Introduction

1.1. Background

Financial counterfeiting has been a prominent issue in the global capital market, which involves the deliberate manipulation of financial statements by enterprises through improper means in order to mislead investors and stakeholders about the true financial position of the enterprise. From big historical cases such as Enlong and WorldCom to LeTV and Comet in recent years, these cases have not only revealed regulatory loopholes, but also exposed deep-rooted problems in the market and corporate governance. Such financial misconduct has seriously distorted the fairness of market operations, undermined investor confidence, triggered market turmoil, and even affected the economic security and stability of the entire country. The motives for financial counterfeiting are varied, including the pursuit of rising stock prices, hiding company losses, meeting performance targets, and obtaining financing. These behaviors often involve sophisticated accounting practices and intentional circumvention of internal controls. Therefore, it is particularly important to study how

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to prevent and combat financial fraud by improving regulations, strengthening supervision, enhancing transparency and improving corporate governance.

1.2. Related Research

1.2.1. Reasons for Financial Fraud

The fraud triangle theory proposed by W. Steve Albrecht is a theory used to explain the causes of corporate fraud. He defines the causes of corporate fraud as three elements - the element of pressure, the element of opportunity and the element of self-creation. That is, the enterprise to create financial fraud must meet the three conditions of pressure, opportunity and self-creation, the lack of any one of these elements, it is impossible to cause financial fraud [1]. GONE theory is also a theory that introduces financial fraud which consists of four factors; Greed, Opportunity, Need, Exposure.The theory suggests that when the four factors can be combined in accordance with the needs of the fraudster, he will put the idea of fraud into action [2].

Wang believes that financial fraud by listed companies is often motivated by the pursuit of illegal benefits, such as enticing investors to provide financing or manipulating share prices [3]. Taking Kangmei Pharmaceuticals as the subject of his study, Jiang argues that its continuous high-intensity expansion is an important pressure factor for it to commit financial fraud. In addition, its over-concentrated and unitary shareholding structure also provides opportunities for financial fraud in Kangmei Pharmaceuticals [4]. Han attributed the causes of financial fraud to the lack of accounting ethics among accountants, over-ambitious company management, high expectations of the outside community, low cost of fraud and low penalties [5]. Cong et al. believe that the cause of financial fraud is the lack of independence of a company's external audit. Firms would bribe the external auditor to make it less independent [6].

1.2.2. Means of Financial Fraud

Meng argues that listed companies usually engage in joint fraud with interested parties in order to cover up their own financial offences so that their own fraudulent acts are not easily identified [7]. Chen argues that companies inflate their revenues by fictionalising non-existent sales operations, such as forging original bills, and at the same time increase their costs and expenses accordingly by certain means, in order to match revenues with costs and reduce the risk of detection when subjected to audits and other inspections [8]. Combined with the financial counterfeiting cases in recent years, Han believes that corporate financial counterfeiting is generally accomplished by means of inflated accounts receivable, inflated currency funds, inflated inventories, and inflated investments [5]. Shen and Lei believe that corporate financial fraud is manifested in two ways: first, by cloaking the income statement in "assets"; and second, by falsifying sales operations [9]. Huang believes that the means of financial fraud is more diversified, mainly including inflated income, inflated prepaid accounts, inflated currency funds, concealment of guarantees for connected transactions, concealment of the use of fund-raising funds and so on [10].

1.2.3. Responses to Financial Fraud

Meng believes that in addition to the strict regulation of financial fraud of listed companies, it is also necessary to focus attention on the financial fraud of listed companies in conjunction with the behaviour of listed companies, the financial fraud of listed companies in conjunction with the behaviour of listed companies to impose stricter and more perfect legal regulation [7]. Li et al. believe that the accounting integrity system should be strengthened. In order to avoid some accountants, tempted by interests, helping enterprises to carry out financial fraudulent activities, disturbing the

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market order of the society and harming the interests of investors and other enterprises, it is necessary to strengthen the professional ethics education of accountants and to play the role of a bridge for accountants [11]. Dai believes that firstly, the relevant monitoring mechanism should be set up to solidify the core business and prepare for potential problems. Secondly, the government should strengthen supervision to stop the occurrence of financial fraud in a timely manner. Thirdly, the industry should strengthen its supervision of possible self-fraudulent behaviour of listed companies, urge them to improve the quality of information disclosure, and use the pressure of audit supervision and potential litigation risks to curb their incentives to commit fraud [12].

1.3. Objective

The fraud of Hangzhou Century Co., Ltd. is the first case since the full registration system that the issuance documents of convertible bonds fabricated material false content, but there are fewer existing studies on this type of financial fraud cases. This paper analyses the causes of financial fraud based on GONE theory, provides insights for regulators, policymakers and scholars, and puts forward effective countermeasures and suggestions to fill the gap in the study of this type of financial fraud.

2. Analysis of the Case

2.1. Overview of the Case

Hangzhou Century is one of the earliest enterprises in China to get involved in the field of medical artificial intelligence, Hangzhou Century Co., Ltd 2021 Directed Issuance of Convertible Bonds to raise 817 million yuan, the bond offering document shows that the financial data of the year 2017-2019, the first three quarters of 2020, the total profit of 156 million yuan, respectively, 162 million yuan, 165 million yuan and 92 million yuan. The administrative penalty book of Zhejiang CSRC disclosed that the documents for the targeted issuance of convertible bonds by Strong Medical had material false content. The company falsely increased its revenue and profit through its wholly-owned subsidiaries carrying out false business, as well as recognising revenue and costs in advance for business related to other companies. The company falsely increased its operating revenue and profit in 2019, of which $33 million, or 20 per cent, of the $165 million in total profit for the year was falsely increased. The company recognised revenue and costs in advance in 2020 by carrying out false business, and the inflated profit in 2020 accounted for 67% of the total profit for the period.

Zhejiang CSRC believes that the act of fabricating materially false content in the public offering documents of Hangzhou Century violates relevant regulations and constitutes an offence. Zhejiang CSRC proposes to decide to fine Sitronix Medical Huizhou 85.7 million yuan; to fine the then chairman and general manager Zhang Gasa Zhong 7.5 million yuan; to fine the then CFO Wang Rin, the then vice-chairman deputy general manager, the secretary Sun Xinjun 3 million yuan; to fine the then chairman of the Supervisory Board, employee supervisor Wang Jun 500,000 yuan, the company and the four responsible persons are proposed to be fined a total of 99.7 million yuan. Zhejiang CSRC intends to decide to take a 10-year market ban on Zhang Lizhong.

2.2. Analysis of Fraud Motivation Based on GONE Theory

2.2.1. Greed Factor (G)

The management of Hangzhou Century may push to maintain or increase the share price in order to maintain investor confidence, especially in times of market volatility or unstable economic conditions. A stable or rising share price not only facilitates the company's capital-raising and financing activities, but also strengthens the confidence and support of investors and potential shareholders in the

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company's future. In addition, management is under extreme pressure to develop their personal careers, and their performance evaluations are often closely related to the company's financial performance, which directly affects their bonus payments and job stability. Therefore, in order to obtain greater financial benefits and career security in the short term, they may misrepresent their performance through various means. Such manipulations may include exaggerating revenues, delaying the recognition of expenses, or using complex accounting techniques to mislead investors and market analysts about the true state of the company's operations. In this way, management aims to create a superficial image of financial health to meet short-term professional and economic goals, which may have a negative impact on the company's reputation and market position in the long term.

2.2.2. Opportunity Factor (O)

Due to the lack of internal controls and auditing deficiencies, Hangzhou Century may have taken advantage of existing regulatory loopholes and auditing deficiencies in its financial operations. A company may create an appearance of active business and a favourable financial position on its financial statements through fictitious transactions by its subsidiaries or inflated revenues and costs with other businesses. Such manipulations include trading goods or services between subsidiaries with each other that do not actually exist, by which revenues are misrepresented or costs are shifted for the purpose of adjusting overall financial performance.

In addition, excessive management control over financial reporting, especially in the absence of adequate oversight and independent internal audit mechanisms, greatly increases the risk of financial fraud. Such control may manifest itself in the editing and adjustment of key financial data, making financial reporting more in line with the objectives set by management rather than a true reflection of the company's operations. In such an environment, even small-scale financial irregularities may gradually evolve into larger-scale financial fraud, as the lack of oversight provides room for misconduct to hide.

2.2.3. Need Factor (N)

Hangzhou Century may be under extreme pressure to perform because of poor performance, competitive markets or the need to meet certain financial benchmarks. Such pressure may arise from creditors' debt constraints, shareholders' expectations and the overall performance of the market. For example, creditors may set specific financial ratios as conditions for borrowing, such as gearing or profitability, forcing the company to meet these standards in order to maintain its access to finance and the stability of its debt structure. In addition, shareholders have certain expectations about the firm's earnings growth and market share expansion, and these expectations may motivate the firm's management to adopt more aggressive financial strategies in the short run.

In addition, management's financial needs may also be closely related to their personal careers. For example, maintaining a position in the company or seeking promotion to a higher position may lead management to take a more optimistic approach to reporting financial results. This may include overemphasising short-term achievements at the expense of long-term financial health and sustainability.

2.2.4. Exposure Factor (E)

When management engages in financial manipulation or other improprieties, they may underestimate the risk that these behaviours will be exposed by an external audit and the legal or market consequences that may ensue. At times, management may mistakenly believe that they can manage these risks by controlling the flow of information or influencing the outcome of the audit process. Such practices may include exerting pressure on the auditor or providing misleading information to hide the true financial position. In addition, despite the obvious potential for risks to be revealed, some management may still believe that, from a short-term perspective, the immediate benefits through financial fraud, such as higher share prices or increased bonuses, outweigh the potential long-term consequences of these behaviours.

3. Recommendations for Preventing Financial Fraud

3.1. Greed Factor (G)

Convertible bonds are often priced based on a company's financial condition and future growth prospects. Financial fraud may result in the price of convertible bonds being higher than their true value, thereby misleading the market and investors and distorting the normal price discovery function of the capital market. Companies can set up an open and transparent system of rewards and penalties and designing remuneration structures to reward long-term rather than short-term performance ensures that incentives are aligned with the company's long-term goals and continued health. The first step is to ensure that the system's criteria and results are transparent to all stakeholders, which reduces the opportunity for individuals or groups to manipulate data to meet objectives. In addition, the system should be based on multiple performance indicators, not just financial results. Including non-financial metrics such as customer satisfaction, internal process efficiency, and the ability to innovate can reduce over-reliance on a single financial metric. And performance targets should be realistic and achievable; setting overly high performance targets may make employees reach their goals through improper means.

Another measure is to set up an equity incentive system to bind employees to the long-term interests of the company and enhance their sense of responsibility through stock options or other equity incentives. To further strengthen the preventive effect of the system, the incentive for employees to resort to manipulation of financial reporting for short-term share price increases can be reduced by setting a long-term holding period for shares or options. Also a portion of equity awards can be set to be paid out on a deferred basis until after the company publishes audited financial results, which can help reduce the incentive for employees to manipulate short-term results.

In addition, companies need to conduct regular employee training to promote good corporate culture and values. By providing regular financial and ethical training to employees, they can increase their awareness of proper behaviour, emphasise the importance of integrity and the consequences of financial fraud, create a work environment centred on ethics and responsibility, and mentally reduce the incentives for financial fraud.

3.2. Opportunity Factor (O)

Financial fraud through convertible bond issuance usually requires internal co-operation and clandestine operations, which may lead to confusion and inefficiency in the company's internal management. Companies can apply the principle of separation of powers and duties to ensure that different finance functions are managed by different people. In the financial process, important tasks should be broken down into steps and completed by different people. For example, one person is responsible for bookkeeping, another for approving transactions, and then a third person for review. This ensures that no one person can complete the entire process involving manipulation or fraud alone. At the same time, key financial positions, such as finance and accounting staff, can be rotated on a regular basis, which can help to expose misconduct that may be hidden due to the stability of positions over time.

The role and effectiveness of auditing is crucial in the convertible bond issuance process. Companies should combine regular audits with cross-audits to increase independence and objectivity. Periodic audits include both internal and external audits, which are usually conducted on a fixed

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schedule. Through regular external audits, companies can demonstrate their financial transparency and integrity to external investors, creditors and other stakeholders, enhancing market trust. Cross audits can reduce bias and increase audit independence by having different teams or departments review each other's work. At the same time, different audit teams may have different expertise and audit methodologies, and cross auditing can lead to new insights and more comprehensive issue identification. Used in conjunction, they can provide more comprehensive risk management and control, and companies can not only better comply with external regulations, but also continuously improve and optimise management and operational processes internally.

3.3. Need Factor (N)

Financial fraud usually triggers market distrust in the company's future financial position and performance, which in turn can lead to volatility in the market price of convertible bonds and related securities. Companies should establish transparent communication and feedback mechanisms. Through transparent communication mechanisms, companies can disclose key financial information and data, including financial statements and audit reports. Such openness can increase the trust of internal and external personnel in the company's financial operations and reduce possible fraud. At the same time, the establishment of open communication channels can allow employees to actively express their stress and difficulties at work and seek help rather than resorting to improper means. Employees can also be encouraged to identify and report any possible financial misconduct, but care should be taken to protect the identity of the whistleblower and to ensure that the report is handled and investigated in a timely manner.

At the same time, companies should set reasonable performance targets to avoid setting unrealistic performance indicators for employees and to reduce the pressure on employees to engage in financial fraud due to failure to meet targets. Performance targets should be in line with the SMART principle, i.e. Specific, Measurable, Achievable, Relevant and Time-bound. This setting ensures that objectives are clear and can be clearly quantified and assessed. At the same time, performance targets should be based on reliable data and facts, not subjective estimates or inaccurate assumptions. This can be supported by market analyses, historical data and industry trends to ensure that the targets are set reasonably. After performance targets have been set, they should be monitored and evaluated on an ongoing basis, which can be achieved through regular performance reviews and feedback mechanisms to ensure that the achievement or non-achievement of the targets is reflected in a timely manner, while also identifying any potential irregularities or unusual data.

3.4. Exposure Factor (E)

Financial fraud in the issuance of convertible bonds may violate securities laws and regulatory rules, and the company and its senior management may face legal action and regulatory penalties. Regulators should enhance effective monitoring and assessment of a company's financial condition to prevent improper financial manipulation and misleading reporting.

First, regulators should regularly obtain accurate financial reports and related information from companies, which need to comply with national and regional laws and regulations, as well as accounting standards. Second, external auditing is an important tool to ensure the authenticity and compliance of financial reports. Audit institutions need to audit and assess the company's financial data on a regular basis, and verify that the company's financial reports reflect the true financial position and operating results through independent checking and analyses. These audit reports not only have important reference value for investors and market participants, but are also one of the important bases for regulators to conduct supervision. Finally, active communication and co-operation is the key to establishing a good corporate governance and regulatory relationship.

Companies should maintain open and timely communication with regulators, respond positively to regulatory enquiries and requests, and work together to safeguard market order and investor interests. Through such co-operation, companies are able to build an honest and transparent corporate image under the supervision of regulators and enhance investors' trust in their financial reporting and operational management.

4. Conclusion

This paper takes the case of financial fraud in the issuance documents of convertible bonds as the research object, uses GONE theory to analyse the motivation and certain consequences of its financial fraud, and gives corresponding preventive measures for different factors of motivation. It is found that the company's motivation in the Greed factor is related to investor confidence in the company and the pressure of management performance evaluation, and the company can take preventive measures such as setting up an open and transparent reward and punishment system, setting up a share incentive system and conducting regular employee training. The Opportunity factor can be attributed to the lack of internal control and auditing deficiencies, which can be prevented by implementing the principle of segregation of duties and responsibilities, and by combining regular audits and cross-audits. The Need factor is related to creditor pressure, shareholders' expectations, and overall market performance, and companies should establish transparent communication and feedback mechanisms, as well as set reasonable performance targets. Finally, in terms of Exposure factor, the lack of strict external regulation and auditing provides an opportunity for financial fraud, and regulators should further strengthen the effective supervision and assessment of the company's financial status in order to effectively prevent financial fraud. Through the above study, investors and market participants can better identify potential risks and enhance their awareness of risk management and compliance, thus promoting the healthy and stable development of the whole market.

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